Exhibit No.:
Issue: Hedging Decisions
Witness: Randal T. Maffett
Sponsoring Party: Southern Missouri Gas Company, L.P. d/b/a Southern Missouri Natural Gas
Type of Exhibit: Direct Testimony
Case No.: GR-2006-0352

SOUTHERN MISSOURI GAS COMPANY, L.P.
D/B/A SOUTHERN MISSOURI NATURAL GAS

DIRECT TESTIMONY

OF

RANDAL T. MAFFETT

Jefferson City, Missouri

September 7, 2007

BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of Southern Missouri Gas Company, L.P.'s Purchased Gas Adjustment Factors to be Reviewed In Its 2005-2006 Actual Cost Adjustment.)	)))	Case No.GR-2006-0352

AFFIDAVIT

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Comes now Randal T. Maffett, having been duly sworn, upon his oath and states that he has caused to be prepared the attached written testimony in question-answer form and attached exhibits to be presented in the above-captioned proceeding; that the answers and information contained therein are true and correct to the best of his knowledge, information and belief.

Randal T. Maffett

Subscribed and sworn to before me this 6th day of September, 2007.

Grace Raven
Notary Public
STATE OF TEXAS
My Comm Exp. Nov. 16, 2010

Notary Public

My Commission Expires: Nov. 16th 2010

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

DIRECT TESTIMONY
OF
RANDAL T. MAFFETT

CASE NO. GR-2006-0352

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Randal T. Maffett. My business address is 1001 Fannin, Suite 550, Houston, Texas 77002.

Q. MR. MAFFETT, WHAT IS YOUR POSITION AND YOUR RELATIONSHIP WITH SOUTHERN MISSOURI GAS COMPANY, L.P. D/B/A SOUTHERN MISSOURI NATURAL GAS, L.C., D/B/A SOUTHERN MISSOURI GAS COMPANY ("SMNG")?

A. I am President and CEO of Sendero Asset Management, which is the managing partner for Southern Missouri Natural Gas.

Q. PLEASE DESCRIBE YOUR EDUCATION AND EXPERIENCE TO THE COMMISSION.

A. I have more than twenty years experience in management and operations in the energy industry, including project development, origination, marketing, contract negotiations, and engineering. During the past two years, I have been actively involved in all major aspects of the management and operations of Southern Missouri Natural Gas, including

decisions related to hedging and gas supply purchasing decisions. A copy of my resume is included as Appendix A.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS COMMISSION?

A. Yes, I have. I have testified on behalf of Southern Missouri Natural Gas in Case Nos. GA-2007-0212, GM-2005-0136, GC-2006-0180 and GR-2005-0279.

Q. ON WHOSE BEHALF ARE YOU SPONSORING TESTIMONY IN THIS PROCEEDING?

A. I am sponsoring testimony on behalf of SMNG.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to address the Commission Staff ("Staff") recommendation of a proposed disallowance for SMNG allegedly having failed to adequately hedge its gas supplies in the 2005/2006 Actual Cost Adjustment ("ACA") period. The Staff recommendation to which I will be responding is contained in a staff memorandum filed in this proceeding on June 8, 2007.

Q. HOW IS THE REMAINDER OF YOUR DIRECT TESTIMONY ORGANIZED?

A. The remainder of my testimony is organized into six sections, as listed below:

I. **Overview of Hedging Techniques**—provides a summary of various hedging instruments, and their advantages and disadvantages for a small LDC such as SMNG;

II. **Rationale For Using Basis Differential Hedging**—explains the reasons why SMNG management chose to utilize basis differential hedging during the Summer and Fall of 2005.

III. **Fundamental Market Conditions During the Spring and Summer of 2005**—provides a summary of the fundamental market conditions, including the record high natural gas futures prices, and the widening basis differentials, that existed in the Spring and Summer of 2005.

IV. **Overview of Staff's Position**—provides a summary of the Staff Recommendation for the 2005/2006 ACA periods, including the proposed level of disallowance;

V. **Prudence Standards**—provides a description of the generally accepted prudence standards utilized in the energy industry and specifically those relied upon in Missouri;

VI. **Conclusions**--Based upon the legal standards adopted by the Commission in previous cases, SMNG should not be subjected to any disallowance of its natural gas costs in this case. SMNG was both prudent and reasonable, and used its best judgment under all the circumstances and using the information that was available at the time, to make its gas purchasing and hedging decisions.

I. OVERVIEW OF HEDGING TECHNIQUES

Q. BEFORE YOU ADDRESS THE SPECIFICS OF THE STAFF RECOMMENDATION IN THIS CASE, WOULD YOU EXPLAIN THE VARIOUS HEDGING TECHNIQUES THAT WERE CONSIDERED BY SMNG DURING THE 2005/2006 ACA PERIOD.

A. Yes. SMNG considered a number of hedging techniques, but because of its size and financial capabilities there were only a limited number of hedging techniques that were realistically available for SMNG to utilize. More specifically, SMNG considered the various pricing structures, mechanisms, and instruments contained in 4 CSR 240-40.018(2), including natural gas storage, fixed price contracts, call options, collars, outsourcing/agency agreements, futures contracts, financial swaps, and other tools utilized in the market for cost-effective management of price and/or usage volatility. As explained below, SMNG decided to utilize basis differential hedges as a tool to cost-effectively manage price and volatility for our customers.

Q. ARE THERE LIMITATIONS ON THE TYPES OF HEDGING TECHNIQUES THAT MAY BE EFFECTIVELY UTILIZED BY SMNG?

A. Most definitely. Small Missouri LDCs such as SMNG have limitations upon their ability to use some hedging techniques. For example, SMNG does not have physical storage available on

its system or the interstate pipeline systems that serve SMNG. As a result, SMNG was unable to purchase and place natural gas in storage during the 2005/2006 ACA period, thereby limiting SMNG's ability to use a fundamental tool to hedge against price volatility.

Secondly, futures contracts require stringent credit collateral to cover potential margin calls resulting from adverse position moves. Small LDCs like SMNG generally do not have the capacity to post such credit.

Similarly, options are generally not available to SMNG due to the high cost of option premiums.

Finally, SMNG serves rural markets in which it must compete for customers against unregulated propane competitors. If the price of natural gas, including the cost of financial instruments or other mechanisms for insuring against price volatility, becomes too high relative to the unregulated propane market, SMNG may be unable to compete for customers, and the financial viability of the system may be jeopardized. As a result, it is particularly important for small LDCs such as SMNG be able to compete with their unregulated competitors, thereby limiting some of its choices.

II. BASIS DIFFERENTIAL HEDGING

Q. PLEASE EXPLAIN THE USE OF "BASIS DIFFERENTIAL" HEDGES BY SMNG.

A. Basis differentials are generally defined as the difference in price between two different delivery points a major component of which is the transportation cost to move the commodity from one point to the other. In our case, Basis is the difference between the NYMEX Futures Price (at Henry Hub) and the Southern Star Central Gas Pipeline Index (SSCGP Index) which is in the mid-continent region. While the absolute price of natural gas and the basis differential generally move in the same direction, either may move more rapidly than the other which is what occurred in the early Summer months of 2005. Historically, the Basis Differential between NYMEX and the SSCGP Index was averaging around $0.20 - $0.30 per MMBtu. In the Summer of 2005 (preceding the hurricanes), SMNG saw the basis grow from its historical range to over $0.50 and eventually $0.90 and more. Because of the lack of fundamental support in the increased NYMEX prices, the basis differential was increasing more rapidly. Ultimately, locking in basis differentials offers a hedger an opportunity to lock in more favorable pricing at a point in the future by locking in a higher discount.

Q. PLEASE GIVE A HYPOTHETICAL EXAMPLE OF HOW THE BASIS DIFFERENTIAL HEDGING WORKS.

A. Okay. For example, assume a normal basis differential is -$0.20 per MMBtu, meaning if the price at the Henry Hub is $7.00 per MMBtu, the Mid-Continent index price is $6.80. Next, assume that the basis differential increases to -$0.75 per MMBtu and the NYMEX price increases to $7.50. With the original basis at -$0.20 locking in a gas price would have resulted in a $7.30 net price. However, if the buyer had also previously locked in the -$0.75 basis differential, the net price would have been $6.75 thereby improving the buyer's position by $0.55 per MMBtu.

Q. IS BASIS DIFFERENTIAL HEDGING A VIABLE ALTERNATIVE FOR SMALL LDCS SUCH AS SMNG?

A. Yes. Basis differential hedging is a very helpful tool for small LDCs such as SMNG that in addition to managing price volatility must also compete head to head with unregulated propane and simply can NOT ignore opportunities to improve its competitive position with respect to price. By locking in basis differentials in favorable markets, SMNG can secure larger discounts from the NYMEX futures index and secure a lower overall price for its customers.

Q. DID SMNG EFFECTIVELY UTILIZE BASIS DIFFERENTIAL HEDGING IN THE 2005/2006 ACA PERIOD?

A. Yes. SMNG looked at the unique markets circumstances that existed during the Summer and Fall of 2005, and decided that basis differential hedging was a reasonable and appropriate strategy. However, it was not intended to be the end but simply a means to an end. In other words, SMNG never intended to execute basis swaps and nothing else. It fully intended on locking in its winter gas prices but saw the basis swaps as a way to increase its discount to NYMEX and further reduce its gas costs. It is important to remember that at the time SMNG executed the basis swaps, there was no fundamental support for gas prices meaning: no significant heat waves creating electric demand, all-time record storage inventories and the fact that the physical cash market was disconnecting from NYMEX as evidenced by the "blow out" in basis being observed. SMNG, as well as a number of its suppliers and other market analysts we conferred with, were of the same opinion that NYMEX was due a major price correction (downward) and felt that locking in these record basis differentials would position SMNG optimally to reduce its gas costs.

Ultimately, SMNG executed basis differential hedges on two separate occasions; one at NYMEX minus 59 cents on July 26,

2005 and another at NYMEX minus 98.5 cents on September 2, 2005. Subsequently, on October 27, 2005, December 27, 2005, and January 3, 2006, SMNG entered into several fixed priced contracts for a substantial portion of its expected natural gas requirements for the winter load, and effectively utilized the basis differential hedges secured in July and September, 2005, to obtain a lower price for its customers for the winter.

III. FUNDAMENTAL MARKET CONDITIONS DURING THE SPRING AND SUMMER OF 2005

Q. PLEASE EXPLAIN THE UNIQUE MARKET CONDITIONS THAT EXISTED AT THE TIME SMNG MADE ITS HEDGING DECISIONS IN THE 2005/2006 ACA PERIOD.

A. During the Spring and Summer of 2005, NYMEX gas prices began approaching record high levels. Schedule RTM-1 shows the NYMEX prices and the basis differentials over this period. However, as discussed below, the market fundamentals did not support the record high NYMEX prices.

Q. PLEASE ELABORATE ON THE MARKET FUNDAMENTALS AND PRICING DYNAMICS THAT EXISTED IN THE APRIL-JULY, 2005 TIME PERIOD.

A. Fundamental market indicators, which are data points used to define overall supply and demand, were suggesting that the

natural gas market was ready for a major correction to lower the price of natural gas. For example, natural gas storage levels were at all-time record highs indicating the lack of demand during the previous months. The Winter of 2004 had been relatively mild and, as a result, storage withdrawals were significantly behind schedule leaving what ultimately was a record high surplus gas left in storage at the beginning of the Spring injection season. Summer temperatures were also relatively mild across most of the country therefore electric A/C demand was substantially lower than expected. With record storage surplus and the lack of current electric generation demand, fundamentals indicated storage would be full much sooner than normal creating a glut of gas in the market. Therefore, we concluded, as did many of our suppliers and market analysts with whom we regularly confer, that these strong bearish signals of an oversupplied market would result in a major downward price correction. However, NYMEX prices were continuing to increase to levels substantially higher than previous years without any fundamental support. If SMNG had locked-in its natural gas price during this period, as it had done in previous years, SMNG would have been locking-in at what were then record high prices and trying to compete with propane that was still being priced at steep discounts.

Q. WERE THERE SOME UNEXPECTED FACTORS THAT SUBSTANTIALLY IMPACTED THE PRICE OF NATURAL GAS IN THE SUMMER?

A. Yes. Two major hurricanes hit the Gulf region over a two week period shutting in approximately 13% of U.S. natural gas production. This in turn caused dramatic spikes in natural gas prices to new record levels at the same time SMNG was looking to execute fixed price contracts for its Winter volumes. If SMNG had executed fixed price contracts on July 26, and September 2, 2005, as Staff is suggesting should have been done, then SMNG would have been locking in record prices substantially higher than all previous winter seasons since SMNG has been in business. SMNG did not believe that such action would be reasonable or prudent because the fundamental market conditions suggested that natural gas prices were due a major correction in the near future. In fact, despite the chaos caused in the Gulf of Mexico, the only contract defaults that occurred were those who chose to take delivery of financial contracts at Henry Hub. In January 2006 after it became apparent that production concerns were overstated, gas prices fell dramatically.

Q. WERE THERE OTHER FACTORS THAT YOU BELIEVE MAY HAVE BEEN AFFECTING THE NYMEX PRICES DURING THIS PERIOD?

A. Yes. Since the advent of NYMEX futures, the volume of speculators trading natural gas futures has dramatically increased. More specifically, in recent years, we have seen a tremendous growth in "hedge fund" trading. Contrary to their names, these funds are pure speculators and add zero value to the overall market as they are unregulated and control vast amounts of capital which they can deploy very rapidly creating significant market movements in the absence of supporting fundamentals. This is exactly what we believed happened in 2005 in the months preceding the two hurricanes. As I have referenced earlier and, as illustrated by the graph on Schedule RTM-1 provided herein, NYMEX prices continued to escalate in the Spring and early Summer months of 2005 despite the fact that weekly storage inventories were setting new all-time records and prompt month demand was relatively non-existent due to the lack of Summer air-conditioning (i.e., electric generation) demand.

IV. OVERVIEW OF STAFF'S POSITION

Q. WHAT IS STAFF'S POSITION REGARDING SMNG'S HEDGING DURING THIS ACA PERIOD?

A. The June 4, 2007 Staff Memorandum outlines Staff's concerns with SMNG's hedging practices for the 2005/2006 ACA period. In the June 4 Staff Memorandum, Staff asserted that SMNG had deviated from its past practice of hedging more than 50% of its normal winter natural gas requirements, and recommended three alternative disallowances related to SMNG's hedging practices. Staff explained SMNG's hedging practices as follows:

> SMNG deviated from this practice of fixing the gas prices for the winter months, November 2005 through March 2006, during the 2005-2006 ACA period. Instead, SMNG utilized a basis differential to fix only the discount off of the NYMEX futures prices for the winter months. A basis differential is the difference in natural gas price from one delivery location to another. SMNG fixed the basis differential two separate times, one at NYMEX minus 59 cents on July 26, 2005 and another at NYMEX minus 98.5 cents on September 2, 2005.
>
> At this point, it is important to note that although SMNG locked in the basis differentials on July 26, 2005 and September 2, 2005, respectively, the total natural gas commodity prices were not yet fixed. In other words, SMNG fixed the basis differentials but decided not to apply the discounts to the NYMEX futures prices on July 26, 2005 and September 2, 2005. SMNG says that since the NYMEX futures prices were at an all time high when the Company fixed the basis differentials, they decided to wait before applying the fixed discounts to the NYMEX futures prices, which would have fixed the total natural gas commodity prices. SMNG's intention was apparently to actually trigger (lock in) the

NYMEX fixed price portion of the deal when the NYMEX futures prices became more favorable later on. Unfortunately, the NYMEX futures prices continued to rise throughout the summer and fall of 2005 amid one of the most devastating U.S. Gulf hurricane seasons and for much of the rest of the year. The Company eventually started triggering the NYMEX fixed price part of gas costs on October 27, 2005, and continued until early January, 2006. Only when SMNG actually fixed the NYMEX part of gas supply costs and applied the previously triggered basis discounts to the NYMEX futures prices, were the total gas prices fixed.

Q. DO YOU AGREE WITH STAFF'S STATEMENT OF FACTS SURROUNDING THE COMPANY'S DECISION TO UTILIZE BASIS DIFFERENTIAL HEDGES RATHER THAN FIXED PRICE CONTRACT HEDGES?

A. While I agree with some of Staff's statements, I adamantly disagree with any implication that SMNG deviated from its past practice and did not act prudently in choosing the basis differential hedging technique under the unique circumstances that existed at the time the hedging decisions were being made. As stated earlier, the basis differential hedges were step one of a two-step process wherein SMNG was trying to lock in what were record discounts. It was always SMNG's intention to lock in fixed gas prices for 50-60% of its winter requirements. We were simply waiting for the market fundamentals to correct what we felt was a significantly overpriced and unsubstantiated NYMEX strip.

It is also important to emphasize the fact that gas purchasing decisions in the real world are made without the benefit of

hindsight. Buyers (and Sellers) are required to follow, analyze and digest many, many data points in an effort to make prudent decisions. It's easy to be a buyer if you've got the benefit of knowing what tomorrow's prices are today!

As also referenced earlier, SMNG is always working to mitigate price volatility but as also referenced earlier, SMNG competes head to head with unregulated propane dealers and has to also work to lower its overall gas cost in an effort to be as competitive as possible.

Q. WHAT IS STAFF'S PROPOSED DISALLOWANCE RELATED TO SMNG'S HEDGING PRACTICES DURING THE 2005/2006?

A. With the benefit of complete hindsight, Staff has proposed three alternative adjustments based upon three alternative Scenarios. All three Scenarios assume that SMNG lock in what would have been record high gas prices. Scenarios I and II assume that SMNG would have locked in the record high natural gas prices that existed on 7/26/05 and 9/2/05 in addition to the basis hedges that were locked in on those dates. Scenario III assumes that SMNG would have locked in 54% of the normal winter volumes on 8/11/05 and 8/24/05 and also applied the actual basis differentials that SMNG had secured on 7/26/05 and 9/2/05. In all three Scenarios, Staff is suggesting that,

on one hand we should have done exactly what we did, i.e., lock in record discounts, but they go on to suggest, again with the benefit of hindsight, that we should have also locked in fixed prices. This is somewhat equivalent to "having your cake and eating it, too".

Staff's proposed adjustment(s) are based upon a comparison of what the hypothetical cost of gas would have been had SMNG utilized the purchasing strategies assumed in the Scenarios, rather than using the Company's actual hedging and purchasing plan. Most importantly, though, the "damages" calculated by Staff are based upon the use of 20/20 hindsight, and not upon the information that was available to SMNG at the time the purchasing decisions were being made.

Q. WHAT ARE THE ALTERNATIVE DISALLOWANCES RECOMMENDED BY STAFF?

A. The Staff has recommended an adjustment to reduce gas costs by $220,453, $264,117, or $378,470 for this ACA period, depending upon which Scenario was adopted.

Q. DO YOU AGREE WITH THE STAFF'S PROPOSED DISALLOWANCES IN THIS CASE?

A. No. SMNG adamantly disagrees with Staff's recommended adjustment to reduce gas costs by $220,453 to $378,470 for

this ACA period. As SMNG has previously explained, SMNG believed it was prudent to utilize basis differential hedges, and lock in all-time high basis differentials (i.e. discounts to the NYMEX) as the natural gas prices soared to all-time high levels following the price increases that resulted from hurricanes and hedge fund activities in the Summer of 2005. Again, it was always SMNG's intent to eventually fix 50-60% of its winter gas requirements but SMNG felt the unsupported high prices would correct. We, nor anyone else, had any way of knowing two major hurricanes would hit the Gulf Coast.

Q. DO YOU BELIEVE IT IS REASONABLE FOR THE COMMISSION TO ADOPT THE STAFF'S PROPOSED DISALLOWANCE?

A. No. It is unreasonable to make a prudence disallowance based upon information (i.e. future natural gas prices later in the winter) that was not available at the time decisions were being made, as Staff is proposing. In fact, the Company used its best judgment, as well as information from many active market participants, based upon the information that was available at the time, to determine what it felt were prudent purchasing and hedging practices for the 2005-2006 winter heating season.

V. PRUDENCE STANDARDS

Q. WHAT IS THE PURPOSE OF A PRUDENCE REVIEW IN UTILITY RATEMAKING?

A. Utilities, as regulated monopolies, have to make investment decisions that balance their obligation to provide safe and adequate service at reasonable rates with their owners' requirement for an opportunity to earn a reasonable return on their invested capital. As I understand the purpose of a "prudence" review, the investments and expenses are reviewed and deemed to be "prudent" by regulatory agencies in order for public utilities to be allowed to recover the costs associated with those investments and expenses from customers through rates. The concept of a "prudent investment" is a regulatory oversight standard that attempts to serve as a legal basis for judging whether utilities have met their public interest obligations and should be able to recover those investments and/or expenses in rates.

Q. WHAT IS THE PRUDENCE STANDARD IN UTILITY RATEMAKING?

A. Based upon my discussions with counsel, it is my understanding that the prudence standard emanates from a 1923 decision of the U.S. Supreme Court in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276

(1923). In a separate concurring opinion, Justice Brandeis explained the prudence standard as follows:

> There should not be excluded from the finding of the [rate] base, investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures. Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown. . . .

Two fundamental principles were established in this opinion. First, only reasonable or prudent expenditures are to be included in a public utility company's rates. Second, a public utility company's expenditures are presumed to be prudent until it can be demonstrated that the expenditures were imprudent through clear evidence of utility misconduct.

Q. HAVE THERE BEEN ADDITIONAL PRUDENCE PRINCIPLES ESTABLISHED IN MORE RECENT YEARS?

A. Yes. The National Regulatory Research Institute ("NRRI"), the research institute affiliated by the National Association of Regulatory Utility Commissioners ("NARUC"), has identified the following four principles to be followed by state regulatory agencies when evaluating a public utility's actions:

1) a presumption of prudence;

2) a rule of reasonableness under the circumstances;

3) a proscription against hindsight; and

4) a retrospective, factual inquiry.[1]

Q. WHAT IS YOUR UNDERSTANDING OF THE FIRST PRINCIPLE?

A. The first principle establishes that there is a presumption of prudence for utility actions. This presumption rests upon the case law stemming from the Brandeis Opinion, i.e. "every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown." (emphasis added). As a result, this presumption of prudence creates a threshold for a party to first overcome in order to challenge further the prudence of a public utility's actions.

Q. WHAT IS YOUR UNDERSTANDING OF THE SECOND PRINCIPLE?

A. The second principle requires that the actions of the public utility's management must be evaluated in light of what was known, or reasonably knowable, at the time the decisions in question were being made. In other words, the decisions must be evaluated based upon whether the decisions and conclusions were appropriate given the information available at that time. While the results of management conduct may be used to rebut a presumption of prudence, the results of management conduct cannot be relied upon to determine whether that conduct was prudent.

[1] The Prudent Investment Test in the 1980s, Burns, Poling, Whinihan and Kelly, 1984, p. 55.

Q. WHAT IS YOUR UNDERSTANDING OF THE THIRD PRINCIPLE, I.E. A PROSCRIPTION AGAINST THE USE OF HINDSIGHT?

A. It is my understanding that a public utility's actions must be based upon the reasonableness of the circumstances that existed at the time the decisions were being made, and therefore, the use of hindsight to evaluate the actions will not result in a supportable finding by the regulatory agency. This requires that factual information from that period be collected and evaluated without consideration of the eventual outcome or result of that decision. Importantly, NRRI has specifically stated that "if a state commission engages in hindsight, any finding of imprudence is subject to reversal."[2] In other words, information available after a decision was made is irrelevant to the prudence evaluation.

Q. WHAT IS YOUR UNDERSTANDING OF THE FOURTH PRINCIPLE, I.E. A RETROSPECTIVE FACTUAL INQUIRY?

A. My understanding of the fourth principle is that a commission must develop a record of the facts, not subjective opinions based upon hindsight, as they existed at the time the utility decision was made. It is this record that should be used to measure and evaluate the public utility's decision against the prudence standard in effect.

Q. DOES THE MISSOURI COMMISSION HAVE AN ESTABLISHED POLICY REGARDING THE PRUDENCE ISSUES IN ACA CASES?

A. Yes. As mentioned in SMNG's Response to Staff Recommendation in this case, in *Re Missouri Gas Energy,* 11 Mo.P.S.C.3d 206, 222-223 (March 12, 2002), the Commission established the legal standard for reviewing the prudence of a natural gas corporation's purchases of natural gas. In this case, Staff had proposed to disallow approximately $3.5 million in natural gas costs incurred by Missouri Gas Energy in its 1996-1997 ACA period. In rejecting the Staff's proposed prudence adjustment, the Commission explained the application of the prudence standard in ACA cases as follows:

> The Commission established its prudence standard in a 1985 case involving the costs incurred by Union Electric Company in constructing its Callaway nuclear plant. In determining how much of those costs were to be included in Union Electric's rate base, the Commission adopted a standard for determining the prudence of costs that had been established by the United States Court of Appeals, District of Columbia, in a 1981 case. The standard adopted by the Commission recognizes that a utility's costs are presumed to be prudently incurred, and that a utility need not demonstrate in its case-in-chief that all expenditures are prudent. "However, where some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling those doubts and proving the questioned expenditures to have prudent."
>
> The Commission, in the Union Electric case, further established that the prudence standard was not based on hindsight, but upon a reasonableness standard. The Commission cited with approval a

[2] Id. at 60.

statement of the New York Public Service Commission that:

> . . . the company's conduct should be judged by asking whether the conduct was reasonable at the time, under all the circumstances, considering that the company had to solve its problem prospectively rather than in reliance on hindsight. In effect, our responsibility is to determine how reasonable people would have performed the tasks that confronted the company. (footnotes omitted)

In the *Missouri Gas Energy* case, the Commission found that the Staff had not raised serious doubts about MGE's purchasing decisions to overcome the legal presumption of prudence, and therefore there was no basis for a prudence disallowance. (Id. at 223-24).

Q. WHAT DID THE COMMISSION'S DECISION IN THE UNION ELECTRIC DECISION RELATED TO THE CALLAWAY NUCLEAR POWER PLANT ESTABLISH RELATED TO THE PRUDENCE STANDARD?

A. In the Callaway Nuclear Plant decision, the Commission addressed both the presumption of prudence, as well as the manner in which a public utility's prudence should be evaluated. First, the Commission cited a Washington, D.C. Circuit Court of Appeals and the Brandeis Opinion, in finding that:

> Utilities seeking a rate increase are not required to demonstrate in their cases-in-chief that all expenditures were prudent. . . However, where some other participant in the proceeding creates serious doubt as to the prudence of an expenditure, then

> the applicant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent.
>
> * * *

Quoting a New York Public Service Commission decision, the Commission elaborated on the prudence standard as follows:

> ". . . the company's conduct should be judged by asking whether the conduct was reasonable at the time, under all the circumstances, considering that the company had to solve its problem prospectively rather than in reliance on hindsight. In effect, our responsibility is to determine how reasonable people would have performed the tasks that confronted the company. . ."

(Report & Order, *Re Union Electric Company*, 27 Mo.P.S.C. (N.S.) 183, 192-94 (1985).

V. CONCLUSIONS

Q. WHAT ARE YOUR CONCLUSIONS?

A. Based upon the legal standards adopted by the Commission in the *Missouri Gas Energy* case, SMNG should not be subjected to any disallowance of its natural gas costs in this case. SMNG was, in fact, both prudent and reasonable and used its best judgment under all the circumstances and using the information that was available at the time to make its gas purchasing and hedging decisions. It is not reasonable for the Staff to "Monday-morning-quarterback" those decisions nearly two years

later using data that was NOT available at the time the decisions were made.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY AT THIS TIME?

A. Yes sir, it does.

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SUMMARY

Over 20 years experience in management and operations in the international energy industry including business and project development, origination, marketing, contract negotiations and engineering. Highly motivated and goal oriented with good leadership and strong team-building skills. Dedicated individual with a strong commitment to both professional and personal excellence achieved through relationships built on integrity and trust.

WORK EXPERIENCE

2004 - Present **Sendero Capital Partners, Inc./President & CEO**

- Initiated and launched an independent asset acquisition, management and private equity investment company focused on the upstream and mid-stream segments of the crude oil and natural gas markets
- Successfully bid on the acquisition of a $45 million natural gas pipeline and distribution business in first 3 months of operation with final closing awaiting regulatory approval anticipated to occur in Jan05
- Structured and negotiated definitive private equity partnership agreements for both the first transaction as well as a commitment for corporate level funding for future project opportunities
- Structured and negotiated definitive debt facilities (acquisition and working capital) for the first acquisition
- Implemented a separate asset management vehicle which will operate/manage all acquired assets on a fee-basis
- Identified numerous additional opportunities currently under review

2002 – 2004 **RWE Trading Americas Inc./Vice President – Origination & Business Development**

- Led and closed the sale of all RWETA's U.S. assets when the German parent decided to exit the U.S. energy market despite the fact we were on target for current and next year's earnings targets
- Developed complete origination and business development platform for start-up company entering the U.S. market including recruiting and building world-class origination/business development team of 12 top industry originators across multiple energy sectors

- Designed, implemented redirected multiple strategic initiatives focused on natural gas, power, crude/refined products and coal commodities including simple customer-based strategies, equity investments, acquisitions and long-term, complex structured transactions such as volumetric production payments, spark-spread tolls, credit sleeves, equity and credit arbitrage, etc…
- Initiated and executed multiple asset acquisition strategies in natural gas, power and crude/refined products
- Originated and implemented internal reporting mechanisms, deal review, risk control and approval processes
- Coordinated and managed all strategic, project and transaction execution with corporate parent in Germany
- Total PV10 of all transactions generated in excess of $150MM with a rolling deal backlog of over 100 transactions

2001 Enron Global Markets/Vice President – Global Crude & Products

- Rebuilt and redirected underperforming origination and mid-marketing businesses focused on crude and refined products worldwide (North America, Europe, Asia/Far East).
- Initiated and completed strategic analysis of business opportunities to align business unit goals and objectives with existing trading operations and synergize those with the demands and needs of the market
- Developed new strategies, markets, products and services from an entirely new customer base
- Significantly improved deal flow/opportunities with P&L impact in excess of $100MM in first 6 months

1997 – 2000 **Enron North America /Vice President – Business Development**

- Specialized in corporate restructurings and turn-arounds of troubled assets/investments valued in excess of $700MM including companies in the oil and gas, environmental/recycling and waste disposal/landfill gas recovery industries.
- Led the disposition of assets and/or the bankruptcy restructuring of two companies representing $500MM in debt and equity investments.
- Represented Enron's equity interests on various Boards of Directors for both domestic and international companies and served as interim CEO during transition and/or sell-off.
- Developed and implemented startup strategies and execution plans for variety of new businesses including power transmission, natural gas storage and offshore producer services. P&L generated over $30MM in first 12 months with deal backlog in excess of $100MM.
- Initiated, implemented and managed strategic alliances with large industrial customers in North America. Primary focus on large, complex, highly structured transactions involving multiple commodity components both within and outside the energy industry. Net P&L in excess of $25MM over 18 month period with significant deal backlog.

997 **Enron International/Vice President - Latin American Business Development**

- Regional manager for business development in Latin America. Responsibilities included evaluation and analysis of mergers and acquisitions, formulating fuel supply/energy commodity marketing, trading and hedging programs and developing downstream financial opportunities and structures for crude/refined products, natural gas and power.
- Managed and supervised regional asset base in Colombia, Argentina and Brazil. Represented EI's interests on various Boards of Directors.
- Coordinated activities with internal business units in order to achieve maximum value through efficient cross-selling of the entire scope of corporate resources, products and services.
- P&L generated in excess of $200MM over 3 years.

1993 - 1994 **Enron Power Services, Inc./Director**

- Negotiated long-term gas sales and financial hedging strategies with non-utility power generators. Origination activities focused on complex integrated projects including pipeline expansions, fuel purchasing and financing strategies and power marketing opportunities. Assisted developers in arranging non-recourse project financing and fuel supply for power development projects.

1989 - 1993 **Altresco Financial, Inc./Director-Fuel Supply**

- Directed and managed all fuel procurement strategies and physical supply logistics. Responsibilities also included all contract administration functions including invoicing, imbalance management, nominations, regulatory and customs filings, monthly operational reports and annual business plans/strategies. Assisted project development teams in negotiating long-term power sales agreements.

- Generated incremental P&L in excess of $5MM from arbitraging fuel supply contracts.
- Part of development team that led the successful financing by GE Capital of two cogeneration plants in the northeast. Assisted in power contract negotiations, pipeline regulatory filings, project permit filings, etc…

1987 - 1989 **Ladd Petroleum Corp. & Delhi Gas Pipeline**

- Delhi Gas Pipeline - Supervised and responsible for marketing over 400 MMcfd of system production on both long-term and spot basis. P&L generated in excess of $5MM in first 6 months.
- Ladd Petroleum - Built and implemented gas marketing program expanding sales from 20 MMcfd (12 customers) to over 300 MMcfd (>100 customers). Increased monthly P&L over 800% in first 12 months. Supervised and managed all T&E responsibilities and personnel including training and quarterly reports. Assisted accounting in developing and streamlining invoice process.

1982 - 1986 **Mobil Oil Corp./Drilling Supervisor & Engineer**

- Supervised and coordinated all rig site activities in the Rocky Mountain region. Designed and implemented drilling and completion programs for various fields throughout the western U.S. Responsible for well cost estimating/AFE's.

EDUCATION

1996 Enron Executive MBA Program - Thunderbird International School of Business Management, Phoenix, Arizona

1983 B.S. Petroleum Engineering, Louisiana State University, Baton Rouge Louisiana

ACTIVITIES, INTERESTS & ASSOCIATIONS

Priority Associates/Campus Crusade for Christ
Board of Directors – Kingwood United Methodist Church
Rocky Mountain Natural Gas Association (officer)
Member - NESA/HGA
Society of Petroleum Engineers (officer)
Kappa Sigma Fraternity (officer)
LSU Varsity Football
Community Organization for Drug Abuse Control (CODAC)
Board of Governors – Kingwood Country Club
Hunting, fishing, skiing, tennis and golf

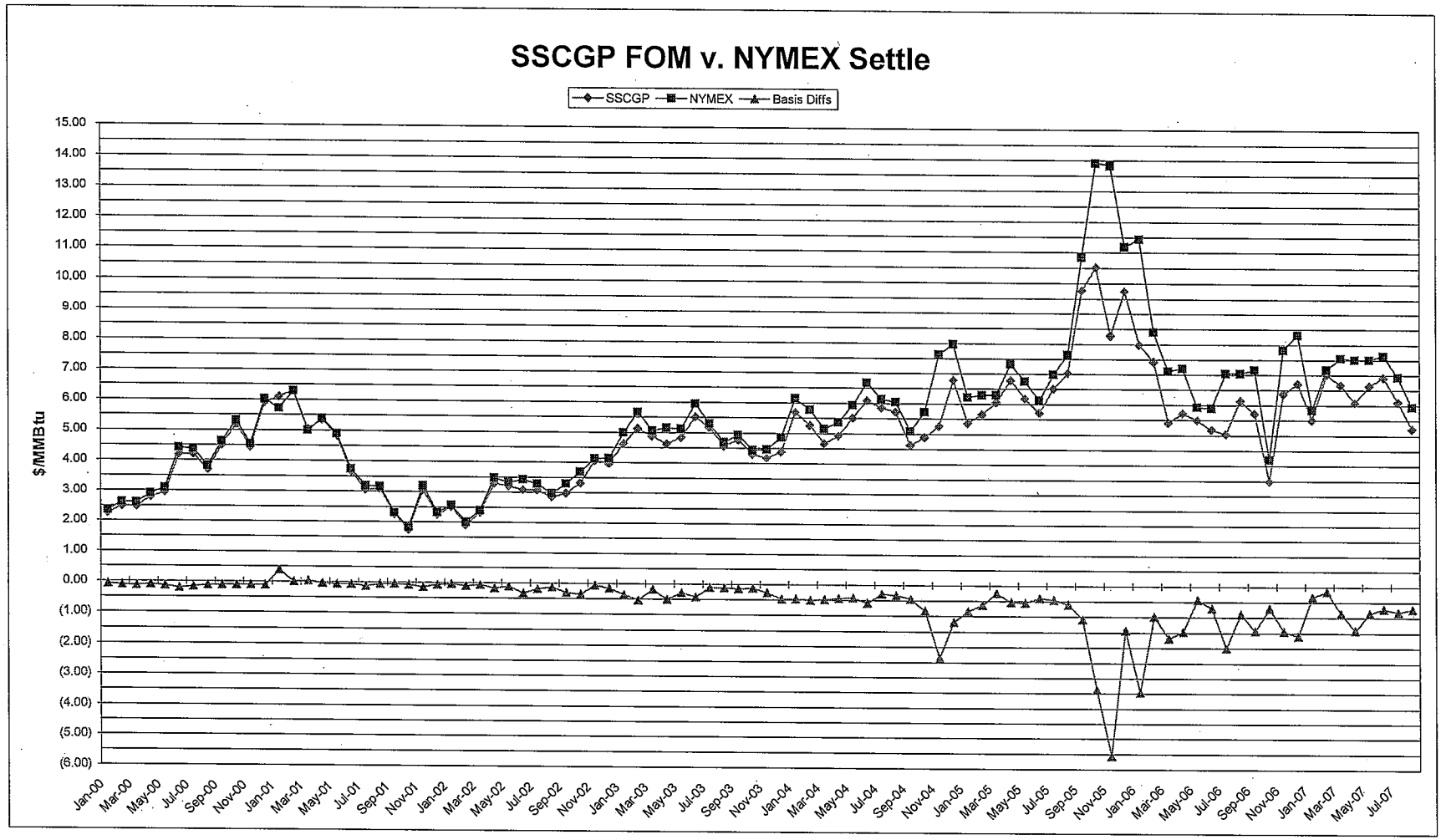
Summary of Skills and Expertise

- Petroleum Engineer undergraduate with good technical, operational and commercial background in the crude/refined products, natural gas and power industries
- Over 17 years in sales, marketing and corporate/business development roles
- Extensive negotiations experience in crude, refined products, natural gas and power markets
- Strong leader with over 15 years of direct supervisory experience including senior executive positions and board roles in both domestic and international private and publicly held companies
- Excellent presentation skills/experience including complex strategic presentations to Fortune 50 Boards of Directors
- Project development experience, including project financing, long-term contract negotiation, vendor/supplier negotiations (pipeline, power, refining/pet-chem, heavy manufacturing, et al)
- Team player who leads by example and is successful at building teams focused on the overall success of the organization ahead of their own personal ambitions
- Good understanding of legal, tax and accounting structures
- Strong understanding of financial derivatives markets and underlying market fundamentals
- Transactional experience includes:
  - Corporate restructurings and/or bankruptcy proceedings
  - Mergers and acquisitions and corporate divestitures (both equity and assets)
  - Oil & gas producer financings
  - Strategic alliances with major corporations
  - Non-controlling/non-operating equity investments including various levels of debt financings
  - Structured commodity transactions and various risk management strategies including cross-commodity swaps and options

Key Transactional Experience

- **Acorn Oil & Gas** – international crude prepay structured as a "quasi" VPP
- **Promigas** – international gas pipeline acquisition with over 40 subsidiaries and development of new natural gas marketing company
- **Metromedia** – retail natural gas supply combined with credit sleeve
- **Project Oz** – cross-commodity supply/off-take contracts to support MBO of major U.S. refinery
- **Energy Bridge** – 20 year LNG supply and marketing contract
- **Everlast** – combination VPP with debt and marketing rights
- **Texaco** – 10 year cross-commodity swap involving heavy crude and natural gas to support large capital investment in new steam flood (EOR) project
- **Powerbridge** – combination VPP with equity and debt components
- **Project Shock** – simultaneous asset divestiture and acquisition with 6 different Fortune 500 companies to create a new $15B energy "super Transco"
- **SolGas** – acquisition of major international LPG importer/supplier/distributor to anchor strategy of developing natural gas pipeline, distribution and marketing company

- **NIDC** – strategic alliance with equity and debt components, marketing rights and long-term fuel supply and power sales/off-take contracts for waste recycling projects
- **Ft. James** – strategic alliance/asset management including 60+ plants in 10 countries
- **GPP** – 5 year energy/asset management contract with fuel supply and power marketing rights
- **Altresco** – IPP/Cogen development and negotiation of 15-20 year fuel supply & power contracts
- **Project Diana** – bond and equity acquisition play for distressed power generation assets
- **Project Buckeye** – 12 year tolling and O&M contract for 4 coal-fired power plants in Midwest
- **NYISO TCR's** – purchase of power transmission congestion contracts in NYISO
- **Project Janus** – structured transaction using above market commodity pricing for distressed assets with an embedded Call Option on the asset at the end of the primary term.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